reasons that because the deferred taxes were "below the line", depreciation of the AFUDC cannot generate above-the-line deferred taxes. The Commission finds that the Company's explanation is correct.

The Commission accepts the Company's adjustment to its side record, which drew no objection, and finds that the Commission Staff-proposed adjustment to deferred taxes is inappropriate.

G. <u>Interest Synchronization, C-16.</u>

Public Counsel/TRACER witness Carver proposes an interest synchronization adjustment, generally referred to as pro forma debt in prior Commission orders, to pro form the effect of the Commission's authorized weighted cost of debt on the Company's Federal Income Tax (FIT) expense. His adjustment determines a level of pro forma interest by multiplying his pro forma rate base times Mr. Hill's weighted cost of debt.

Mr. Carver notes the absence of an interest synchronization adjustment in Staff's case. He states that it is important to adjust the interest expense effect on o the level of interest that the ratepayer is required to pay through the rate of return.

Staff accepts this adjustment in principle, with one modification. That modification is to include interest on CWIP as part of pro forma interest. Public Counsel/TRACER accept the Commission Staff revision for the inclusion of CWIP in the calculation.

The Company argues that it is inappropriate to use a hypothetical capital structure and therefore it is inappropriate to make a pro forma adjustment to interest. The Company's argument appears groundless. Even the Company's original weighted cost of debt was based on a capital structure and cost of debt from one point in time and not exactly equal to test year averages. Further, as Mr. Carver testified (TR 2416-2417), USWC had unamortized investment tax credit on its books during the test period. Investment tax credits are not subtracted from rate base, as are accumulated deferred taxes. USWC as an "option 2" company under tax regulations is allowed to earn its authorized return on the unamortized portion of these credits. The return is to be equal to the overall return found appropriate by this Commission. As Mr. Carver testified, the regulator is allowed to synchronize the tax benefits of the assumed interest costs allowed to USWC. Therefore, in order to represent correctly the tax benefits of interest to be paid for by the ratepayers, and allowed by current tax regulations, the Commission accepts Mr. Carver's proposed adjustment. The Commission has recalculated this adjustment based on the findings in this record, and the effect is an increase to NOI of $4,925,548.

Commission Staff proposed to include CWIP in the calculation of pro forma interest. The Commission notes that there is no testimony supporting Staff's modification. The Commission is aware that in many previous orders CWIP was included in the calculation to the extent companies were not required to capitalize interest for tax purposes. As there is no evidence to support this modification in this proceeding, it follows that the Commission will exclude CWIP from the calculation.

Excluding CWIP from the calculation raises the concern of how tax benefits of interest on construction will be flowed through to the ratepayers. In this proceeding only, the Company will be authorized to normalize the tax benefits of interest associated with CWIP, if they exist, by accruing AFUDC on projects when interest is not capitalized for tax purposes, at the authorized return net of tax rather than at the authorized return. This is the same method used to calculate the allowance for funds used to conserve energy (AFUCE) for Puget Sound Power and Light.[39]

H. Uncontested Adjustments

The following adjustments are uncontested and are accepted as portrayed: Adjustments RMA-1, 2, and 4 through 7; RSA-4, 6, 8, 9, 11, and 15; RSA 17-OOP-1, 3, and 5 through 8; PFA-12; and SA-10.

VI. RATE BASE

The parties disagreed on a number of matters relating to calculation of the Company's proper rate base for regulatory purposes. The differences are shown in the Table attached to this Order as an Appendix, as set out in Public Counsel's brief.

A. Working Capital, Adjustments PFA-3, PFA-4, PFA-5, & SA-7

The Company proposes three components of working capital: pension asset, cash working capital (lead lag study), and materials and supplies.

1. Pension Asset

The Company proposes to include the pension asset as a discrete item in rate base. Ms. Wright discusses the pension asset adjustment, PFA-3, which increases rate base by $69.9 million.

Ms. Wright says that the pension asset is created when the Company credits pension expense, because the pension fund is larger than the pension liability. This asset has been created since the Financial Accounting Standards Board (FASB) adopted SFAS 87, a statement of principle on pension accounting. The Company argues, as it did in Docket No. UT-930307, that credits to expense have been flowed through to the net operating income used in the sharing proceedings and general rate analysis.

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[39] See, WUTC v. Puget Sound Power & Light, Cause Nos. U-90-1183 and -1184, 3d and 4th Supp. Orders.

Commission Staff opposes including a pension asset in rate base at all. It argues that the pension asset should not be allowed to earn a return twice, once in the pension fund and once in the rate base.

The Commission accepts the Company position on this adjustment. All of the return earned in the fund is used to reduce the need for further investment by the Company, and thus it works to reduce the pension expense. That was the Company's position in Docket No. UT-930307. The Company's proposal appears to be consistent with the prior order.. The order in that docket states that the Commission does not question the prudence of the asset, and that the reason for rejection at that time was merely that it should be examined in conjunction with a total working capital analysis such as the one presented in this proceeding.

2. Lead-Lag or Investor Supplied Working Capital Study

The Company proposes a lead-lag analysis to measure working capital. Ms. Wright's analysis, summarized in Exhibit 199 shows a negative working capital of approximately $5 million. However, when combined with the direct inclusion of the pension asset ($70 million) and material and supplies (PFA-5, $4.7 million) she contends that the total working capital at current rates is nearly $70 million. For comparison, Ms. Wright also presents a calculation of working capital using the approach accepted by the Commission in the most recent Puget Power general rate case. That analysis (see Exhibit 157) reveals a working capital of $135.6 million. This analysis was not performed on a total company basis but rather on a Washington State basis to be consistent with Mr. Cummings, the Company's cost of money witness.

Mr. Zawislak presents Commission Staff's calculation of Investor Supplied Working Capital (ISWC), adjustment SA-5, which would replace Company adjustments PFA-3, -4, and -5, Pension Asset, Cash Working Capital, and materials and supplies. These adjustments are all related to the working capital issue. The Company included the pension asset and materials and supplies directly in rate base, and then calculated cash working capital through the use of a lead-lag study. Mr. Zawislak calculated working capital using the investor-supplied approach. His approach includes materials and supplies in working capital, but his calculation removes the pension asset from working capital and thus from rate base in total. The Company's calculation of total working capital is $70 million, while Staff's is a negative $46 million, for a difference in rate base of $116 million.

The major difference between the Company and the Commission Staff in working capital is related to Staff's exclusion of the pension asset, discussed above. The remainder of the difference is embedded in the calculations and the difference in methods. Mr. Zawislak also compares his ISWC approach to the method proposed as a check by Ms. Wright in her Exhibit 157, and contends that Ms. Wright's calculation is based on an incomplete Washington State balance sheet, that in fact does not balance. He contends that it is pieced together from different sources. His working capital calculation is based on total USWC financial statements.

The Company argues that the ISWC approach may be used only when Commission Staff demonstrates that a company's lead-lag study is inadequate. It contends that its ability to present the ISWC study is severely limited by the fact that USWC does not maintain jurisdictional balance sheets. It argues that the Commission Staff approach does not account for differences between jurisdictions in capital recovery policies, authorized rates of return, or taxation (contending that states that rely on sales taxes will have smaller working capital adjustments than states relying more on property taxes). It urges that the lead-lag approach will avoid the problems with the Commission Staff ISWC methodology.

Commission Staff argues that the ISWC methodology is superior because it provides a comprehensive review of all items in a total investor supplied working capital analysis, consistent with the Commission's January, 1995, order in Docket No. UT-930074, resolving USWC's petition to implement FCC and Financial Accounting Standards Board accounting for post-retirement benefits. Commission Staff contends that the Company analysis is incomplete and Ms. Wright's ISWC "test" is based on a hypothetical balance sheet that was not in balance prior to the calculation. It accepts lead-lag studies in concept, but opposes the Company's proposal

The Commission accepts the Commission Staff approach to working capital in this proceeding. The Commission believes that it is more comprehensive and more accurate than the lead-lag approach. It allows the calculation to take place in the context of a balance sheet analysis of company performance rather than examining limited factors. While we understand the Company's situation, not having a readily available Washington balance sheet to work from, we believe that the additional accuracy gained from making the effort to prepare the balance sheet outweighs the expedience available in the lead-lag study. Consequently, we accept the Commission Staff methodology.

3. <u>Declared Dividends</u>

The Company contends that, if a balance sheet approach is used, the Commission must include declared dividends as an element of invested capital. It reasons that once dividends are declared, they are a liability owed to investors. It cites a leading accounting text in support of its proposition.

Commission Staff merely states that both Company and Commission Staff exclude declared dividends, citing USWC witness Mr. Haack as acknowledging that they are a short-term liability and that the funds are zero cost capital to the company.

The Commission accepts the Company's approach and views declared dividends as investor-supplied capital. The Commission notes that in many previous proceedings concerning other companies (for example, Puget Sound Power and Light), dividends payable were excluded from invested capital. The Commission by this order is not reversing those decisions. The circumstances and evidence provided in this record are different. Most notably, USWC is a subsidiary of USWI, and all dividends are thus payable to USWI at its discretion.

In summary on working capital, the Commission adopts Staff's method of calculating total working capital. The Commission rejects the Staff treatment of the $529 million pension asset as a non-operating investment. The Commission will treat the $96.8 million dividends payable as invested capital. As a result, total investor supplied working capital for USWC is $181 million. The Commission will directly allocate the $69.9 million pension asset to Washington intrastate operations. The resulting negative balance will be allocated consistently with Commission Staff's calculation in Exhibit 651, for a negative $37.8 million working capital allocated to Washington. The resulting net working capital is $32,119,086.

VII. Conclusion and Table

The following table sets out the results of the Commission's deliberations on net operating income and rate base elements

US WEST COMMUNICATIONS
WASHINGTON INTRASTATE OPERATIONS
TWELVE MONTHS ENDING OCTOBER 1994

LINE NO			COMMISSION FINDINGS NOI	COMMISSION FINDINGS RATE BASE
1	NET OPERATING INCOME & RATE BASE - PER BOOKS		$89,076,000	$1,473,014,000
	ADJUSTMENTS:			
2	RMA #1	DEREGULATED MOBILE RADIO	$276,544	($813,085)
3	RMA #2	MERGER EXPENSE	8,797	(239,208)
4	RMA #3	AFUDC (MEMORANDUM IDC)	(2,499,012)	23,140,741
5	RMA #4	POLITICAL ACTION EXPENSE	9,819	0
6	RMA #5	DEPRECIATION REFUND AMORTIZATION	(3,003,288)	16,796,490
7	RMA #6	DEPRECIATION RESERVE	16,905,658	128,295,423
8	RMA #7	FLOW THROUGH OF NON-PROPERTY TAX	801,812	4,547,960
9	RMA #8	OPEB	97,331	(7,036,298)
10	RMA #9	SHARING ADJUSTMENTS	0	(31,035,616)
11	RSA #1	OCCUPATIONAL WAGE ANNUALIZATION	(1,972,844)	0
12	RSA #2	MANAGEMENT SALARY ANNUALIZATION	(747,663)	0
13	RSA #3	RATE REDUCTION	(4,442,152)	0
14	RSA #4	RENT COMPENSATION	(63,000)	0
15	RSA #5	AFFILIATED INTEREST BILLING ADJUSTMENT	1,232,375	0
16	RSA #6	PENSION CREDIT REDUCTION	(740,377)	0
17	RSA #7	FEDERAL INCOME TAX ADJUSTMENT	1,071,554	1,902,019
18	RSA #8	INSIDE WIRE AMORTIZATION	173,885	134,000
19	RSA #9	PRIMARY TOLL CARRIER	(3,929,557)	0
20	RSA #10	CLASSIFICATION ADJUSTMENT	711,913	0
21	RSA #11	PURCHASE REBATE ADJUSTMENT	282,169	0
22	RSA #12	COMPENSATED ABSENCE ADJUSTMENT	390,000	0
23	RSA #13	TEAM & MERIT AWARD ADJUSTMENT	6,384,966	0
24	RSA #14	BENEFIT EXPENSE ADJUSTMENT	711,076	(64,341)
25	RSA #15	PROPERTY TAX RESTATEMENT	84,787	0
26	RSA #16	FLOW THROUGH TAX RESTATEMENT	13,033,193	10,898,426
	RSA #17	OUT OF PERIOD ADJUSTMENTS		
27		OOP #1 PRE-DIVESTITURE TAX ISSUES	(73,855)	0
28		OOP #2 ASSET CLEARANCE	222,024	0
29		OOP #3 ACCOUNT RECONCILIATION	821,489	0
30		OOP #4 INCOME TAX	(496,570)	[illegible]
31		OOP #5 PROPERTY TAX	(1,951,422)	0
32		OOP #6 LEGAL SETTLEMENT	(197,320)	0
33		OOP #7 INDEPENDENT COMPANY	894,215	0
34		OOP #8 PURCHASE REBATE	(1,227,247)	0
35	PFA #1	OCCUPATIONAL WAGE INCREASE	(3,381,860)	0
36	PFA #2	MANAGEMENT SALARY INCREASE	(1,482,081)	0
37	PFA #3	PENSION ASSET	0	69,915,604
38	PFA #4	CASH WORKING CAPITAL	0	0
39	PFA #5	MATERIAL AND SUPPLIES	0	0
40	PFA #6	CAPITAL RECOVERY	5,049,375	1,165,240
41	PFA #7	RURAL SALES	4,210,071	(43,542,000)
42	PFA #8	AMORT. OF DEBT CALL PREMIUM EXPENSE	539,257	0
43	PFA #9	RESTRUCTURING ADJUSTMENT	11,408,953	(11,766,524)
44	PFA #10	OPEB CURTAILMENT LOSS	0	0
45	PFA #11	INTERCONNECTION WITH INDEPENDENTS	0	0
46	PFA #12	POSTAGE	(449,476)	0
47	SA #1	YELLOW PAGES	50,934,378	0
48	SA #2	HELD ORDERS	0	0
49	SA #3	JURISDICTIONAL SEPARATIONS	6,805,250	(35,722,831)
50	SA #4	MARKET RESOURCE GROUP	1,052,896	0
51	SA #5	INVESTOR SUPPLIED WORKING CAPITAL	0	(37,796,518)
52	SA #6	RURAL SALES SETTLEMENT	0	0
53	SA #7	BRI	2,374,375	0
54	SA #8	ADVERTISING ADJUSTMENT	0	0
55	SA #9	REGULATORY FEE (COMPANY OOP #9)	178,682	0
56	SA #10	CHARITY CONTRIBUTIONS	0	0
57	SA #11	EXTERNAL RELATIONS	338,911	0
58	SA #12	OVERTIME AND CAPITALIZATION	0	0
59	C-1	RECURRING REVENUE	9,508,000	0
61	C-16	INTEREST SYNCHRONIZATION	4,925,548	0
62	C-11	OCCUPATIONAL ANNUALIZATION	0	0
63	C-12	MANAGEMENT ANNUALIZATION	0	0
64	C-6	BELLCORE DISALLOWANCE	606,000	0
65	C-7	USWAT PROJECT DISALLOWANCE	286,000	0
66	C-8	US WEST INC. CHARGES	0	0
67	TOTAL ADJUSTMENTS		$115,673,579	$88,779,482
68	NET OPERATING INCOME ADJUSTED		$204,749,579	$1,561,793,482

VIII. Rate of Return

The Company's overall authorized rate of return is calculated by determining the interest rate that the company pays on debt and the investor's required return on equity, then multiplying those rates by the proper proportion of each source of capital in the Company's ratemaking capital structure.

The parties' positions at the conclusion of the proceeding are set out in the accompanying table.

COMPARISON OF RATE OF RETURN CALCULATIONS

	Public		
	Company	Counsel	Staff
	Cummings	Hill	Folsom
SHORT TERM DEBT			
Ratio	10.267%	9.100%	9.100%
Cost Rate	6.170%	6.000%	5.390%
Weighted Cost	0.633%	0.546%	0.490%
LONG TERM DEBT			
Ratio	33.167%	38.900%	31.000%
Cost Rate	7.050%	7.200%	7.600%
Weighted Cost	2.338%	2.801%	2.356%
PREFERRED EQUITY			
Ratio	0.000%	0.000%	4.900%
Cost Rate	0.000%	0.000%	8.500%
Weighted Cost	0.000%	0.000%	0.417%
COMMON EQUITY			
Ratio	56.567%	52.000%	55.000%
Cost Rate	12.500%	11.250%	11.55%
Weighted Cost	7.071%	5.850%	6.353%
RECOMMENDED RATE OF RETURN	10.043%	9.197%	9.615%
NET OF TAX	9.003%	8.026%	8.619%

A. Cost of Debt

The calculation of cost of debt is rendered somewhat more complex by additional debt issues after the Company's original case was submitted, and by the Commission's acceptance of Mr. Hill's hypothetical capital structure.

The parties agree that the Commission Staff cost of debt should be used if the Commission accepts the Commission Staff-proposed approach to amortizing debt call premium. As we have done so, above, we accept the Commission Staff cost of debt here for the Company's original case capital structure

We price the Company's recent additional debt at its actual cost, as derived by comparison of Mr. Cummings' direct and rebuttal presentations.

Finally, based on the total capital in Mr Cummings' rebuttal case, less Commission Staff's adjustment for debt call premium, we add the additional debt required by Mr. Hill's hypothetical capital structure. We price it at Mr. Hill's proposed cost for new issues -- which is somewhat higher than the rate at which the Company was able to finance its recent issues.

The resulting long term cost of debt is 7.57%. We have adopted Mr. Hill's short term cost of debt at 6% as consistent with the Commission-determined capital structure.

B. Cost of Preferred

The Commission Staff proposed the use of preferred stock in a hypothetical capital structure, and offered a proposed rate. As described below, we accept Mr. Hill's hypothetical capital structure and include no preferred stock in the calculation of rate of return.

C. Cost of Equity

The Commission has reviewed the testimony on cost of equity that has been presented by the parties. We conclude that USWC experiences less risk than USWI and the other regional holding companies (RHCs). We believe that the effect of the lower risk can be measured through the cost of equity and/or the capital structure. The Commission accepts the arguments of Staff witness Folsom and Public Counsel/TRACER witness Hill that the extent of unregulated markets participated in by the regional holding companies creates a higher level of business risk associated with the total operations of the holding companies as compared to the regulated telephone operating companies.

The Commission rejects Mr. Cummings' proposal to use a group of non-telephone comparable companies. The Company's own case argues that Mr. Hill's use of gas distribution companies is not comparable. Those companies have lower bond ratings and higher debt ratios than are experienced in the telephone industry, facts that should tend to produce equity returns which are higher -- but as argued by Mr. Cummings and admitted by Mr. Hill, the gas companies are generally considered to have lower equity return requirements. So, too, the AA-rated industrial companies have capital structures with approximately 73% equity, yet their bond ratings are no higher than the bond ratings of USWC. The conclusion one draws is that these companies carry greater business risk, and it is difficult at best to conclude that the measurement of these companies' equity capital is comparable to that of USWC.

The Commission concludes, as represented by Mr. Hill, that the gas companies in his sample are of lower risk, and have lower equity return requirements than does USWC. The USWC equity cost rate should be greater than Mr Hill's findings for this group.

The Commission rejects the use of the independent telephone companies as proposed by Mr. Cummings and Ms. Folsom. The Commission agrees with Mr. Hill that this group of telephone companies displays greater risk by their higher levels of penetration into unregulated markets. Further, the Commission is not convinced that the three-stage growth factor postulated by Ms. Folsom is appropriate, particularly as it relates to these independents.

The Commission finds the discounted cash flow results for the RHCs to be in the range of 11.73% as shown by Ms. Folsom, to 11.86%, shown by Mr. Cummings. As stated above, the Commission agrees with Commission Staff and Public Counsel/TRACER that USWC is of lower risk than the regional holding companies. However, for the most part we believe our authorized capital structure, discussed below, reflects this effect. We find an equity return range centered at 11.8% to measure investor requirements.

The Commission finds no reason to adjust this return for issuance costs as argued by Mr. Cummings. We find Ms. Folsom's arguments convincing that the real costs of issuance would only have a de minimis effect. The range of DCF results by each of the witnesses within the group of regional holding companies is far greater than any proposed effect for issuance costs. Finally, with all stock held by USWI, the actual issuance costs would be negligible.

The Commission finds that Ms. Folsom's range for the regional holding companies is from 11.0 to 12.7%; Mr. Hill's range for those companies is from 11.0 to 12.3% and Mr. Cummings' range is from 11.4 to 12.8%. Each of the witnesses shows a standard deviation of about 50 basis points for the study group's DCF results.

As discussed in the quality of service section, the Commission finds it necessary to provide an incentive for the Company to make improvements in its service quality, by adjusting the Company's authorized cost of equity capital to the lower end of the reasonable range. We find that a 50 basis point adjustment from the center of the range is appropriate to reflect the lack of quality customer service. The Commission thus finds an authorized equity rate of return for USWC in this proceeding of 11.3%.

D. Capital Structure

The Company urges the Commission to accept its actual capital structure of 56.6% equity and 43.4% debt. It contends that no party demonstrates that USWC 's capital structure is either unreasonable or uneconomical.

Mr. Cummings supports the Company's actual capital structure. He states that this capital structure is lighter in equity than USWC's target capital structure, but indicates that the Company is not likely to make great progress toward its target of 60% equity in 1995. He points out that this capital structure has more debt and less equity than the average RHC or independent operating company, around 41%.

Ms. Folsom for Commission Staff proposes to modify the Company's capital structure by adding preferred stock in place of some common equity. She contends that the capital structure needs to balance economic risks and costs of shareholder funding with those of debt funding. She states that this Commission has several times in the past adopted just that for USWC or its predecessor, PNB. She states that USWC's actual capital structure, with 59.9% equity, is too rich in equity She points out that USWC's debt ratio is significantly below the required Standard & Poors AA bond benchmark of 42%, and further that USWC's capital structure includes no preferred stock, which is less expensive than common equity. She indicates that her hypothetical structure still includes a debt ratio of less than 42%. The use of preferred stock adds economy to the capital structure, she suggests, without increased leveraging. Further, Ms. Folsom rejects the concept of double leveraging, as she believes that the change in ownership of the operating company should not affect the cost of capital.

Mr. Hill also proposes a hypothetical capital structure, including 52% equity and 48% debt. He states that the company's actual capital structure, containing 56.6% equity, is excessively rich in equity. He identifies the following capital structures: USW Inc. has 47% equity in its capital structure; USWC regulated 60.29% equity; USWC double leveraged is 52.05%; Value Line Industrials have a 56.3% equity ratio; Value Line Gas have a 50% equity ratio (excluding short term debt); Value Line Gas and Electric are at 44% (before short term debt); and the RHCs have an average 50% equity ratio.

Mr. Hill contends that USW Inc., the RHCs, Value Line's industrial composite, and the independents used by Mr. Cummings in his estimate of common equity costs, all are entities with greater risk than USWC-Washington regulated activities. He argues that the in each case, the companies participate in substantially more competitive markets than the USWC regulated Washington operations. He argues that monopoly utility services are perceived as lower risk and the investor requires a lower return than similarly debt rated entities. While Mr. Hill agrees with Staff witness Folsom that the use of a double-leveraged capital structure is not proper, he notes that Ms. Folsom does not analyze impacts of leveraging. He argues that a holding company, such as USW Inc., can financially cross-subsidize its more competitive (therefore more risky) ventures by including more equity in the regulated operation than necessary for the efficient financing of the regulated operations. He points out that on a regulated basis a 60% or even a 56% equity ratio is substantially higher than the consolidated USW Inc. equity ratio of 47%.

Mr. Hill also looks to the gas industry which, he argues, faces similar risks to those faced by local exchange companies. Despite these similarities, Mr. Hill does not believe that gas distribution companies are perceived to be as risky as the telecommunications industry.

Public Counsel/TRACER argue that Mr. Cummings recommends the use of an actual capital structure without performing an evaluation of the most basic standards: Safety and Economy. They argue that Mr. Hill did present evidence that his recommendations would produce reasonable results. They argue that the Earnings Before Interest and Taxes Plus Depreciation and Amortization (EBITDA) studies are theoretically valid, noting that the company has placed some reliance on EBITDA themselves. They point out that Public Counsel is not recommending $35 billion in debt, but note that the study indicates the level of safety being experienced by USWC even at a 60% debt ratio. Finally, they argue that the benchmarks of the rating agencies are advisory not absolute.

Mr. Hill cites the gas company equity range of 44-47% to be below the proper ratio for the telecommunications industry and establishes the 47%, also USW, Inc.'s consolidated equity ratio, as the bottom of the range appropriate for a local telecommunications company. He argues that top of the range should be significantly below the Value Line industrials average equity ratio of 56%. He identifies the 52% regulated leveraged equity ratio used to finance USWC and uses it as the top of the range. In this proceeding he chooses the 52% as the acceptable equity ratio. After identifying the 52% equity ratio, Mr. Hill goes on to demonstrate the safety of his proposed capital structure through comparison of earnings before interest and taxes to the company's total interest expense. His comparison also includes interest as if the Company had been only 40% equity financed.

Mr. Hill states that the use of preferred stock, as proposed by Ms. Folsom, does not achieve the desired goal that she stated. He indicates that while the market cost is similar to long term debt rate, the tax implications make preferred substantially more expensive than debt. He also states that the use of preferred stock is not common in the telephone industry.

Mr. Cummings opposes Mr. Hill's proposed capital structure. Mr. Cummings contends that Mr. Hill's reliance on financial reporting capital structures is inappropriate, and that the use of the financial reports is not in agreement with the investment used for ratemaking. He argues that Mr. Hill's proposed capital structure is inconsistent with the risk associated with the company's AA bond rating and looks more like an A or BBB rated company. Mr. Cummings argues that Mr. Hill's cross-subsidization argument uses inconsistent data, namely financial reporting for U S WEST, Inc, versus regulatory structure for USWC. He also argues the reverse, that is, use of Mr. Hill's capital structure, may result in cross-subsidization of USWC. With respect to Mr. Hill's safety analysis, Mr. Cummings states that the results simply produce unreasonable results. He argues that the level of debt ($35.5 billion) assumable under Mr. Hill's analysis would produce results that could not be considered financially safe by rating agencies or investors.

The Company argues that Mr. Hill's references to financial reporting capital structures of his comparable companies is improper and that regulatory capital structures should have been used, instead. Public Counsel/TRACER respond that the regulatory capital structure is 52% equity, adjusted for parent company leverage, is an example of the excess of the company's actual structure.

Conclusion: In reviewing capital structure,

> The Commission's function is to set as the appropriate capital structure for ratemaking purposes that structure which best balances economy with safety (WUTC v. Continental Telephone co. of the Northwest, Cause No. U-81-14, 2d Supp. Order (1981).)

The Commission accepts Mr. Hill's analysis and his proposed hypothetical capital structure. We find that Mr. Hill's proposal best balances safety with economy. We find that the existing capital structure is unreasonable and unwise for the company and that it so unreasonably and substantially varies from usual practice as to impose an unfair burden on the consumer.

We find it significant that US WEST Inc can set the Company's capital structure at whatever level best fits with its larger corporate objectives, rather than whatever is the best balance between debt and equity for both business and ratepayer concerns for USWC as a stand-alone company.

Mr. Hill's proposal is supported by comparable data and it is shown to be both economical and safe by earnings volatility tests

E. Commission's Rate of Return/Capital Structure

Type of Capital	Ratios	Cost Rates	Weighted Costs
Long term debt	38.9000%	7.570%	2.945%
Short term debt	9.100%	6.000%	0.546%
Preferred equity	0.000%	0.000%	0.000%
Common Equity	52.000%	11.300%	5.876%
TOTAL	100.000%		9.367%

IX. Revenue Requirement Determination

Pulling together the financial elements of this Order, the following table shows the calculation of the Company's revenue requirement

In calculating the Company's revenue requirement, it is necessary to use a conversion factor to account for such factors as taxes, to derive the number of pre-tax revenue dollars needed to produce the required net operating income. The parties' briefs do not state that there are disagreements as to the appropriate conversion factor to use. Consequently, we use Mr. Hua's proposed factor in this calculation

Derivation of Revenue Requirement

Pro Forma Rate Base	$1,561,793,482
Authorized Rate of Return	9.367%
Return Requirement	$ 146,293,195
Pro Forma Net Operating Income	$ 204,749,579
Net Operating Income Deficiency (Surplus)	($ 58,456,384)
Conversion Factor Multiplier	1.565458
Revenue Deficiency (Surplus)	($91,511,013)

PART FIVE:

RATE DESIGN ISSUES

I. Policy

The parties agree that the policy factors that are most significant are those set out in Chapter 80.36 RCW, especially those in RCW 80.36.300.[40] The Commission keeps those factors in mind as it reviews the issues and makes its decisions on individual elements of this proceeding and on this matter as a whole. In particular, the statutory goal of universal service is a significant element of Washington State policy goal. It underlies many of the parties' arguments, particularly those of Public Counsel/AARP for achieving low residential exchange rates. USWC has contended that universal service may be maintained despite substantially higher residential local exchange rates than exist at present.

Universal service remains a primary and continuing Washington State policy. The Commission notes the existence of a pending docket aimed specifically toward exploring the meaning of universal service in a changing economic and regulatory environment (Docket No. UT-950724). The Commission will make no close examination of universal service in this proceeding. First, the other cause is pending and its scope will go substantially beyond the issues as they are framed in this matter, and second, by virtue of the revenue reduction that we find to be required we are not faced with rate increases that might threaten the existing universality of local exchange service. The topic will be addressed in the pending proceeding.

The principal policy issue that the parties chose to address is competition -- the role of competition in transitional regulation, the correct response of a regulated utility to encounters with competition, and even whether "competition" as each party defines it exists.

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[40] The statute reads as follows:
80.36.300 Policy declaration. The legislature declares it is the policy of the state to:
(1) Preserve affordable universal telecommunications service;
(2) Maintain and advance the efficiency and availability of telecommunications service;
(3) Ensure that customers pay only reasonable charges for telecommunications service;
(4) Ensure that rates for noncompetitive telecommunications services do not subsidize the competitive ventures of regulated telecommunications companies;
(5) Promote diversity in the supply of telecommunications services and products in telecommunications markets throughout the state; and
(6) Permit flexible regulation of competitive telecommunications companies and services.
(1985 c 450 § 1).

Throughout the proceeding the Company has contended that it is beset with competition on all sides and that the Company should be permitted to set prices as though marketing issues were the predominant criteria. Time and again, it supported proposed pricing not by factors involving cost, but by factors involving marketing.

The Company contends that the goals of this proceeding are to establish a realistic revenue requirement for USWC and to rebalance rates to reflect competitive realities. The Company argues that need exists now, not in the future, and it contends that failure to respond is potentially unlawful and confiscatory. It bases its rate restructure principally on the need to meet market requirements.

Commission Staff, however, responds that USWC vastly overstates the existence of and near term prospects for competition. It urges that the level of competition that exists today is not strong enough to substitute for regulation in constraining prices and providing customers choices.

Commission Staff cites Mr. Selwyn's suggested goals for the transitional environment: (1) minimize duplication by requiring resale and unbundling; (2) promote entrants' efficient use of the existing network; (3) promote development of networks through private investment so competitors have comparable risks and rewards; (4) promote greater responsiveness to specialized needs than feasible for a single provider -- i.e., encourage "niche" providers. The Commission finds that these goals are appropriate, and it has considered them in its rate design deliberations.

Public Counsel/AARP contend that the Commission should "expose the fiction" that residential rates are subsidized, and make a specific finding that residential rates are not subsidized. The Commission believes that the evidence is overwhelming that local exchange service does cover its total service long run incremental costs (TSLRIC) -- even as calculated by the Company in its Average Service Incremental Cost (ASIC) presentation -- and makes that clear in its discussion of residential rates, below

Public Counsel/AARP contend that USWC has alleged that it faces competition but that it has not presented objective evidence on market share, market power, or the existence of price-constraining competition. The Commission finds this to be true, and it observes that this is one of the central factors in the result of this proceeding. It is uncontested that some entrants are preparing to provide or are providing competitive services. It is also uncontested that the future holds many unknowns. Cable television providers may package two-way telecommunications with one-way programming services. Wireless services may supplant rather than supplement wire-based communications in the future. Internet-based services may provide a viable alternative to measured toll service. The future presents a multitude of options, any or many of which may ultimately take a significant share of the Washington State telecommunications market.

But USWC has presented no credible evidence that the future is upon us to the extent that we may shift regulatory focus from costs to market-based pricing. USWC made no showing that the nascent competition of which it presented anecdotal evidence has the power to constrain prices. The Commission anticipates that at some point, it will indeed be necessary to shift regulatory focus from costs to market prices -- but that point requires the existence of effective competition that can constrain prices. USWC can achieve a shift toward market pricing by securing competitive classification of particular services through the statutory mechanisms for doing so -- which requires a demonstration that the service is subject to effective competition. The Company could negotiate or seek approval of an AFOR in which pricing flexibility is granted and earnings regulation relaxed as part of a larger agreement.

We are sensitive to USWC's situation and its concerns. We find our Order to be consistent with the transitional market that now exists and with sound preparation for competitive markets. We also will authorize the Company to file banded rates for any service that it believes is likely to face competition. Banded rates provide as much pricing flexibility as the law -- and our duty to protect captive customers -- permit. See, RCW 80.36.340.

Public Counsel/AARP ask the Commission to end USWC's use of "black box" cost studies by announcing a number of specific cost study requirements; the Commission will address those matters below.

The Department of Defense/Federal Executive Agencies (DOD/FEA) argues that the federal government needs viable competitors for its contracting policies to work effectively to save the government money. The Commission believes that its actions in this order do promote the development of effective competition in a way consistent with both State and Federal law. DOD/FEA cite to the recently-enacted Federal Telecom Act and its role in advancing implementation of effective competition for local exchange service.

The Washington State Department of Information Services argues that the Commission should promote competition (or at least do nothing to hinder competition). Again, we believe that our actions are consistent with advancing competition in a way consistent with law and all parties' rights. WITA, the Washington Independent Telephone Association, asks the Commission to consider policy choices from the perspective of all players so that clear and appropriate signals are sent. We have done our best to do so in this Order.

II. Cost Studies

This case is the first in which this Commission has attempted to measure on a systematic and consistent basis the costs incurred by USWC to provide various services. There has been remarkably little debate about the need to measure service-specific costs as one element of determining reasonable and sufficient rates. Nor has there been great disagreement that costs should be measured from the ground up, i.e., on a long-run, incremental, going-forward basis and without consideration of the actual costs incurred in the past by USWC.

The degree of consensus about the need to do cost studies and the need to do them on a long-run incremental basis is in stark contrast with the lack of consensus about the specifics of the cost calculations. Parties disagree about virtually every aspect of the cost study process, notably about what constitutes an incremental cost, what costs should be included in a study, and what analytical model should be used to calculate costs.

In addition, while there is general agreement about the need for studies, there is substantial disagreement about what should be done with cost studies. The parties do agree that rates for individual services should not be set below incremental cost so as to have one service subsidizing another service. Many parties identify particular services that they believe should be priced at or very near incremental cost. Some parties acknowledge, and the Commission finds, that setting all rates at incremental cost would not produce enough revenue to meet USWC's revenue requirement, which is determined on the basis of its embedded costs. Except for USWC's flawed Average Direct and Shared Residual Cost (ADSRC) calculations, no party offers a systematic approach to reconciling the revenue requirement of the firm with the incremental costs of individual services.[41]

To address the contested issues regarding methodology and cost study inputs, it is important first to state clearly the purpose to which the end product will be put: The Commission will use incremental cost studies primarily to establish price floors for individual services. When USWC introduces a new service or seeks to lower the rates for an existing service, it is important to ensure that the rates at least cover the incremental costs of providing that service. Guarding against cross-subsidy and predatory pricing is the primary function of the incremental cost studies.

The Commission will use incremental cost studies secondarily to guide and inform its decisions on rate spread in this case. No party has suggested any sort of mechanistic relationship between incremental costs and rates, such as an equal percentage markup over incremental costs, and any such formula would appear to be inappropriate. It could, for instance, result in rates for some services that would exceed the revenue-maximizing level. It would be foolish to set rates so high that the service actually produces less revenue than it would at a lower rate. Neither are rates based on equal markup over incremental cost necessarily fair. An equally "fair" rule, with potentially very different rates, would be to have equal discounts from the stand-alone cost of each service.

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[41] The record also is silent as to the appropriate price ceilings for various services. Incremental costs provide a theoretical price floor for each service: the price of a service should at least equal the costs that the firm would not incur if it were to cease providing the service. If prices are set lower than incremental cost, other firms could be prevented from entering the market, even if they have lower costs than USWC. The price ceiling, by contrast, would be defined as the costs that a firm would incur if it were to provide a particular service on a stand-alone basis. Local exchange service, for example, should not be priced above the cost of building a stand-alone network of loops and switches dedicated solely to local service. Public Counsel argues that the price ceiling for local service is obtained by including the local loop in the cost of local service. The Commission does not accept this argument, because it assumes without factual basis that other shared and common costs would be avoided in a local-only network.

Incremental cost studies provide one more useful tool in determining fair, just, reasonable, and sufficient rates for individual services, but they do not in themselves determine those rates. Other considerations, such as the traditional factors discussed by TRACER,[42] remain an important part of the rate-setting process.

A. Methodology

USWC's cost studies measure Average Service Incremental Cost (ASIC), Shared Residual Cost (SRC), and Average Direct and Shared Residual Cost (ADSRC). The main points of contention are whether and how to account for shared costs; whether to include the cost of the loop in the incremental cost of one or more services; and what analytical model to use.

The Commission finds, consistent with the presentations of most parties that addressed cost issues, that the appropriate measure of costs is Total Service Long Run Incremental Cost (TSLRIC). The Commission has found this measure of costs to be appropriate in prior cases.[43] Incremental costs are appropriate because they measure the additional costs that are incurred by providing an additional service. TSLRIC therefore represents the economic price floor. If the revenues from a service exceed the TSLRIC of that service, then that service is not being cross-subsidized. If the firm were to stop providing that unit, its revenues would fall by more than its costs.[44]

1. Inclusion of Shared Residual Costs

The Commission rejects the concept proffered by USWC of incremental costs that include what it labels variously as "shared," "family," or "group" costs. USWC's cost studies measure Average Service Incremental Cost (ASIC), Average Shared Residual Cost (ASRC) and Average Direct and Shared Residual Cost (ADSRC) in the following relationship:

$$ADSRC = ASIC + ASRC$$

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[42] The cited elements are the following:
1. Effectiveness in yielding total revenue requirements under the fair return standard; 2. Fairness in the apportionment of total costs of service among different consumers; and 3. Efficiency in discouraging wasteful use of services while promoting all justified types and amounts of use, in view of the relationships between costs incurred and benefits received.

[43] Notably, these are the orders in the "term loops" case, 4th Supplemental Order, Docket No. UT-930957, et al., and in the Interconnection case, 4th Supplemental Order, Docket No. UT-941464. The Commission acknowledges that the latter order remains involved in post-order process.

[44] Having prices exceed their respective TSLRICs is a necessary but not sufficient condition in determining whether those prices are fair, just, reasonable, and sufficient. That determination requires consideration of a much broader set of factors than the TSLRIC of the service.

The Commission agrees with Staff, Public Counsel, and others who argue that ADSRC is not a relevant measure of the economic cost of providing a service. ASIC is the element in USWC's studies that most closely approximates TSLRIC. Inclusion of SRC in incremental cost results would allow USWC to manipulate costing concepts to suit its pricing purposes. It could assign more of the shared costs to services that have captive customers.

USWC contends that ADSRC, while not the economic price floor, is a useful measure for setting prices of individual services. It urges that pricing at ADSRC ensures the recovery of shared residual costs from the group of services that share the SRC. It contends that under almost no circumstance should a service be priced at ASIC, the theoretical price floor. If the Commission chooses to ignore the ADSRC in declaring cost floors, argues USWC, the shared and common costs must nonetheless still be recovered in prices.

The Commission agrees that shared and common costs, if they qualify as a part of the Company's revenue requirement, must be considered in setting rates. It does not follow, however, that doing so requires that rates be set at ADSRC. The ADSRC value may be useful to USWC's management as a pricing target, and there is nothing wrong with its use as a management tool when it prices unregulated services. It should not, however, define either the floor or the target for regulated ratemaking.

2. Inclusion of the Local Loop in Incremental Cost Studies

USWC includes the cost of the local loop in its calculation of the TSLRIC of local exchange service. According to USWC, allocation of any loop costs to access and toll service violates the principle of incremental costing, because the entire loop cost would exist even if no carrier access or toll services were provided

Public Counsel/AARP argue that USWC has significantly overstated the incremental cost of local exchange service by including the cost of the local loop, which they assert is not incremental to local service. Their argument is that the loop would be required to offer virtually every other service besides local exchange service and, therefore, that the cost of the local loop is not incremental to local exchange service. Since the loop is required if USWC is to provide any one of toll service, access service, or local service, it is incremental to none of the services.

The Commission finds, consistent with the presentations of Public Counsel/AARP, and other parties that the cost of the local loop is not appropriately included in the incremental cost of local exchange service. The local loop facilities are required for nearly every service provided by the Company to a customer. Neither local service nor in-state long distance service nor interstate long distance nor vertical features can reach a customer without the local loop. Should USWC cease to provide any one of these services, its need for a local loop to provide the remaining services would remain. The cost of the local loop, therefore, is not incremental to any one service. It is a shared cost that should be recovered in the rates, but no one service is responsible for that recovery. USWC's presentation that the local loop is appropriately and necessarily an element of the cost of local exchange service, made through the testimony of witness Farrow, is not credible in light of the purposes of a long run incremental cost study and is inconsistent with accepted economic theory regarding such studies.

USWC argues that allocation of any loop costs to access and toll service violates the principle of incremental costing, because the entire loop cost would exist even if no carrier access or toll services were provided. This argument addresses why loop costs should not be included in the incremental cost of toll and access, but it does not explain why they belong in the incremental cost of local service. The argument applies equally well in application of the costs to local exchange service. Indeed USWC's brief supports the principle that the loop is a shared cost rather than the direct cost of any one service:

> All multi-service firms have shared and common costs by definition, but they are particularly significant for a LEC, which offers very capital and expense intensive local services which require a separate loop from the central office to every premise in its service territory.. (USWC brief, 11).

Our conclusion that the local loop is correctly treated as a shared cost is consistent with the testimony of USWC's cost witness Brian Farrow, who testified:

> U S WEST recommends that the Commission deal with the recovery of loop costs as a pricing exercise. The loop costs calculated in U S WEST's cost studies calculate the loop costs as though the loop is the cost object. The recovery of those costs is a pricing exercise. (Ex. T-338, p. 14)

Commission Staff offered a different approach to the treatment of loop costs in incremental cost studies. Staff argued that the cost of the loop should be allocated to services that use the loop based on a formula adopted by the Commission in Docket No. U-85-23. In that case the Commission said that loop costs should be recovered 25% from interstate toll, 16.95% from intraLATA toll, and the remainder, 58.05%, from local service. Thus staff's calculation of the incremental cost of local service includes 58.05% of the cost of the local loop. Commission Staff argues that the loop costs are not part of the incremental cost of local exchange service but are allocated to local exchange and toll service because of the Commission's past orders. Staff contends that the assignments adopted in U-85-23 were reaffirmed in the recent interconnection order, where the Commission said:

> [T]he residential cost study contains a basic flaw: USWC improperly allocates 100% of the local loop to residential service, and 0% to services that rely and depend on the use of that facility.

> The Commission in the past has addressed this issue and found it appropriate to allocate a portion of the loop costs to toll and other services. See, Eighteenth Supplemental Order, Cause No. U-85-23, et al (December 1986). Vertical services such as call waiting, or any other services that use the loop, should receive an allocation of the loop's costs.]Fourth Supplemental Order, Docket No. UT-941464, p. 39.]

Staff reads too much into this section of the Interconnection order. The question before the Commission in that case was whether residential local exchange service was priced below its incremental cost. In the quoted passage the Commission merely noted that the Company had made an error in its calculation by including 100% of the loop cost but less than 100% of the revenues derived from use of the loop. Based on the decision in U-85-23, one should not expect local service to be expected to cover 100% of loop costs, because some loop costs had been assigned to other services. The issue here is much broader and should not be controlled by the assignment provided for in U-85-23.[45]

3. Choice of an Analytical Model and Documentation for that Model

USWC submitted incremental cost studies that were developed using various in-house cost models. The manuals alone for these models (Ex. 340) are about 1 1/2 inches thick. Other parties have criticized USWC for lack of adequate documentation and access to these models, as well USWC's use of proprietary data in the models. AT&T goes beyond merely saying that USWC should do a better job with its models and argues that the Commission should take cost studies out of USWC's hands:

> The Commission should rely instead on independent studies that use publicly available information. In sharp contrast to the impenetrable maze presented by US WEST, such studies employ transparent methodologies to evaluate verifiable, nonproprietary data. (AT&T rate design brief, 11)

[45] The allocation factors proposed by Staff can be likened to the ADSRC methods proposed by USWC. Both approaches provide a mechanism for allocating shared costs such as the local loop to individual services for pricing purposes. Neither approach yields the economic price floor or accurately measures the incremental cost of a service. Even as a pricing principle, either method would produce arbitrary results that do not reflect either competitive realities or the public policy considerations that should guide the setting of individual rates.

AT&T suggests the Hatfield Model as the nonproprietary replacement for estimating the cost of basic local telephone service.[46] The Hatfield Model uses publicly-available (that is, non-confidential) cost information from USWC and other sources, and it incorporates elements of the Benchmark Cost Model that has been presented to the FCC by USWC and others in the context of universal service funding.

MCI also suggests the Hatfield Model "deserves serious attention by the Commission." TRACER recommends that the Commission consider in the future use of the Hatfield Model. Neither Staff nor Public Counsel address the merits of the Hatfield model, but both parties criticize USWC's approach as a "black box" whose operation is not understandable.

USWC opposes use of the Hatfield model to estimate the incremental cost of its local service, arguing that its methodology and inputs are invalid. The model was designed to identify geographic areas that are expensive to serve, USWC argues, not to estimate the average cost of serving all areas. USWC argues that AT&T has not provided documentation for the model and has not justified much of the data used as inputs. Another problem, USWC contends, is that the model uses embedded costs in some cases.

AT&T responds that the model is publicly available; indeed, it uses an intermediate Benchmark Cost Model whose developers include USWC. AT&T argues that the study's incremental cost calculations use as much USWC-specific data as is publicly available, and that this reliance on publicly available data represents a strength of its approach, since the results can be audited more easily. The Commission agrees. Every cost number supplied by USWC has been marked "confidential." Using USWC's estimates therefore requires that we set rates without the ability to tell the public the costs on which those rates are based. In some cases that secrecy may be necessary, but it certainly should be avoided where reasonable alternatives exist.

The Commission rejects USWC's cost studies for local service and the local loop. The most reasonable and accurate measure of incremental cost for these services on this record is provided by the Hatfield model sponsored by AT&T. While USWC complained that the Hatfield Model is inaccurate as to USWC, it provided little verification of its claim. We are satisfied from comparisons of underlying assumptions and comparisons of inputs that it accurately reflects costs incurred by USWC and that, if it errs, it likely errs on the high side through the inclusion of an overhead factor. Correcting the USWC local exchange model with the tools and input available also provides verification for the Hatfield model.

For other services, no party offered an alternative to studies prepared using USWC's models. The USWC models for services other than local exchange, without shared costs and with appropriate inputs as discussed below, are not precise but are sufficient for reference purposes to estimate incremental costs of services other than local exchange service and the local loop.

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[46] See, Ex. 760-T, pp 4-17; Exhibits 761-T, 762, 763, 764, 765-T, 766, and 767.

4. Overhead Factor

Commission Staff proposes to increase all incremental cost values by an "overhead factor" of 16.41%. The Hatfield Model sponsored by AT&T includes an overhead factor of 6%. Incremental costs usually do not include overhead or administrative costs of the firm, recognizing that those costs will be incurred regardless of whether a particular service is offered. Staff argues that overhead costs actually are sensitive to the number of services being provided. There may be merit to the Staff concerns, but the solution is to identify those costs and include them directly in incremental costs rather than impose an across-the-board multiplier on all results. Moreover, the use of such a factor would suggest more precision than actually exists in the cost study results, which are at best estimates of the actual incremental cost of providing each service. The proposal to inflate incremental costs by an overhead factor should be rejected.

B. Inputs

Some disagreement involved the propriety of various elements of data to be considered (called "inputs") in an appropriate study.

1. Depreciation Rates

The Commission has determined that for regulatory purposes, cost studies should use the depreciation rates prescribed by the Commission. USWC submitted cost studies with greater depreciation expenses, i.e., faster depreciation. Staff, Public Counsel and others argue that USWC should use the economic lives prescribed by the Commission in setting the company's depreciation rates. The parties appear to agree that incremental cost studies should reflect the economic life of the facilities. Their disagreement centers on whether the Commission's depreciation rates reflect the best estimates of economic life (as Staff claims) or a policy of understating depreciation in order to hold down current rates (as USWC claims).

USWC argues that the prescribed depreciation rates are outdated (three years old) and based on backward-looking historical data. USWC says the Commission already decided in the interconnection order that real, current expense inputs should be used in cost studies.

According to Commission Staff, however, "The (Commission-)prescribed lives are economic lives, they are just not the economic lives the Company wants." (Commission Staff Rate Design brief, p. 13). Staff's argument is correct.

The Commission determines appropriate depreciation rates for regulatory purposes on a frequent basis. As noted in a prior Order in this proceeding, the Commission has just completed a review of depreciation methodology and rates and has approved changes. The Company has sought judicial review of that decision and although now on remand to the Commission, review is not complete. Other depreciation groups will be reviewed very soon in a collaborative procedure called "represcription" involving representative s of the Company, the

Commission Staff, and the Federal Communications Commission. That process, which recurs every three years, is now beginning and according to the record it is typically completed swiftly. The depreciation rates challenged by the Company are rates that were considered in the prior proceeding or are subject to review in the represcription process. The Commission finds that the authorized depreciation rates are proper for cost study use and that they sufficiently reflect USWC's costs that they may be used in an accurate cost study and for ratemaking purposes. We see no reason to approach matters on a piecemeal basis, litigating matters incessantly, when it is both functional and appropriate to make a single and consistent timely determination of appropriate depreciation rates for all regulatory purposes. The function of depreciation, estimating the actual economic lives of physical properties, is identical in every instance. It is far better to have a single consistent and timely approach to depreciation than to relitigate it unnecessarily.

2. Cost of Money

In the interconnection case, Docket No. UT-941464, the Commission determined a forward-looking cost of money may be appropriate for use in a cost study. Parties do not appear to disagree with this principle, though their opinions vary on the right estimate of cost. In addition, Public Counsel argues that using the last-authorized rate of return could provide stability and prevent relitigation of cost of money in rate design cases. The Commission agrees that any theoretical advantage to using "pure" forward-looking values would be more than offset by the practical problems of turning every cost-based rate filing into a cost of money case. The last authorized rate of return provides a reasonable measure of the cost of money for this purpose and will be accepted as an appropriate principle.

3. Fill Factors

"Fill factors" describe the amount of unused capacity that will be included in the cost of a particular service. USWC argues that actual fill levels are often below the objective or planning level and that using objective fill factors would cause the cost of spare capacity necessary to provide a particular service to be treated as a shared cost of all services. USWC says the use of objective fill understates the true cost of particular services and that actual fill factors should be used instead. Staff and Public Counsel have presented evidence that actual fill factors would produce excessively high estimates of incremental cost.

The Commission has previously ordered USWC to develop cost estimates using objective fill factors, and we will continue to require the use of objective fill. In situations where capacity is being underutilized, incremental cost calculations would include costs of capacity that is not required to provide that level of service. That would be inconsistent with the theory that incremental cost studies should be prepared on a forward-looking basis and without respect to the actual costs incurred in the past. Using objective fill will assign a reasonable portion of unused capacity to individual services. The remaining unused capacity is most appropriately treated as a shared cost. This issue ultimately has no effect on whether USWC recovers the cost of this unused capacity, since shared costs also are recovered in rates.

4. Wire Pairs in Residential Loop Cost

USWC's cost study for residential exchange service and the residential loop includes the cost of three wire pairs. USWC includes only a single pair in the cost of a business loop. Only one pair (plus a fraction to allow for bad wires, which is accounted for in the objective fill value) is required to provide service. Staff and Public Counsel argue the three-pair assumption overstates the cost of a residential line. Additional pairs are installed only because USWC expects residential customers to order additional lines. The Commission so finds. The cost of the additional pairs should be matched with the additional-line service for which they are installed and should not be included in the cost of the first line [47]

5. Weighting of Design Types

The USWC cost studies do not estimate the cost of every possible combination of loop lengths, switches, etc. Instead, costs are developed for several designs, and these are weighted to arrive at an overall number for incremental cost of average service. Public Counsel argues that the weights are based on judgment and not properly documented. Public Counsel contends that USWC was unable to show how the actual distribution of access lines matches with its design types. USWC's cost witness, Mr. Farrow, responding to questions from the bench, said that the weighing is based on an analysis of Washington state data.

The Commission accepts USWC's explanation for this proceeding. However, it is an example of the more general and continuing problem relating to documentation and auditing of USWC's cost studies. Other parties *must* be able to verify USWC's results if the company's cost studies are to be relied upon in setting regulated rates. Parties have provided specific recommendations as to how USWC can improve its documentation. Until those improvements are made, the Commission will limit its reliance on USWC's results and will encourage parties to sponsor alternative results such as those of the Hatfield model.

C. Results

The most important question to be answered by cost studies in this case is whether residential local exchange service is being cross-subsidized by business and toll service. USWC argues that this cross-subsidy exists and is undermining its ability to remain competitive. Other parties, including Staff, Public Counsel, TRACER, MCI and AT&T, argue that the residential local service rate covers its incremental cost

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[47] The three-pair error has no direct bearing on the decisions of this case, because the Commission has already rejected USWC's entire residential exchange service and local loop cost study in favor of the Hatfield model results. This error was one factor in the Commission's decision to rely on the Hatfield model results. US WEST's argument that it will be grievously deprived of its rights and its opportunity to recover its costs if the additional pairs are deemed shared or common rather than incremental costs in its cost study is silly, as the Company is allowed under regulation to recover both its shared or common costs and its incremental costs.